



## STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	5/16/02	Bill No:	AB 2662
Tax:	Property	Author:	Bogh
Board Position:		Related Bills:	

### BILL SUMMARY

This bill would allow a single member limited liability company owned by an organization that is organized and operated for charitable purposes, as specified, to qualify for the welfare exemption.

### ANALYSIS

#### Current Law

Revenue and Taxation Code Section 214 provides for a “welfare exemption” under which property is exempt from property taxation if it is used exclusively for religious, hospital, scientific, or charitable purposes, and it is owned and operated by funds, foundations, or corporations meeting numerous statutory requirements.

Under current law, property owned by a single member limited liability company (hereinafter Single Member LLC) does not qualify for the welfare exemption provided in Section 214 of the Revenue and Taxation Code. As set forth below, the Single Member LLC is not a qualifying entity under Section 214, nor is there any legal authority that allows the Single Member LLC's status as an entity separate from its owner (a nonprofit corporation exempt under federal and state income tax law) to be disregarded for purposes of qualifying for the welfare exemption. Accordingly, under existing law property owned and operated by a Single Member LLC could not qualify for the welfare exemption.

#### Proposed Law

This bill would add subdivision (k) to Section 214 to provide that property used exclusively for religious, hospital, scientific, or charitable purposes and owned and operated by a limited liability company having a single member religious, hospital, scientific, or charitable fund, foundation, or corporation, which property and fund, foundation, or corporation meet all the requirements of subdivision (a) of Section 214 may qualify for the welfare exemption.

#### In General

**Welfare Exemption.** Under Section 4(b) of Article XIII of the California Constitution, the Legislature has the authority to exempt property (1) used exclusively for religious, hospital, or charitable purposes, and (2) owned or held in trust by nonprofit organizations operating for those purposes. This exemption from property taxation, popularly known as the *welfare exemption*, was first adopted by voters as a Constitutional Amendment on November 7, 1944. With this amendment, California became the last of 48 states in the country to provide such an exemption from property taxes. The ballot language in favor of the amendment stated:

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These nonprofit organizations assist the people by providing important health, citizenship and welfare services. They are financed in whole or in part by your contributions either directly or through a Community Chest. It is good public policy to encourage such private agencies by exemption rather than to continue to penalize and discourage them by heavy taxation.

When the Legislature enacted Section 214 of the Revenue and Taxation Code to implement the Constitutional provision in 1945, a fourth purpose, *scientific*, was added to the three mentioned in the Constitution. Section 214 parallels and expands upon the Constitutional provision by exempting property used exclusively for the stated purposes (religious, hospital, scientific, or charitable), owned by qualifying nonprofit organizations if certain requirements are met. An organization's *primary* purpose must be either religious, hospital, scientific, or charitable. Whether its operations are for one of these purposes is determined by its activities. A qualifying organization's property may be exempted fully or partially from property taxes, depending on how much of the property is used for qualifying purposes and activities. Section 214 is the primary welfare exemption statute in a statutory scheme that consists of more than 20 additional provisions. Over the years, the scope of the welfare exemption has been expanded by both legislation and numerous judicial decisions.

**Owned and Operated Requirement.** Section 214 requires that, to be eligible for the welfare exemption, both the owner and the user of a property must meet specific requirements. The first step in determining welfare exemption eligibility is to determine if the organization itself qualifies. In brief, an organization must meet the following requirements:

- It must be organized and operated for exempt purposes;
- It must not be organized or operated for profit;
- The owner organization must have an IRC §501(c)(3) or Revenue and Taxation Code 23701d letter of exemption;
- The user organization may also qualify with an IRC §501(c)(4) or Revenue and Taxation Code §23701f or §23701w letter;
- The organization's earnings must not benefit any private shareholder or individual;
- Articles of Incorporation must contain an acceptable statement of irrevocable dedication of the property to exempt purposes;
- Articles must contain an acceptable Dissolution Clause; and
- The property owner must be the owner of record on the lien date.

Where there are different owners and operators, property is not eligible for exemption unless the **owner and operator** meet the specific requirements of Section 214. An operator is a user of the property on a regular basis, with or without a lease agreement. Typically, the owner and operator are one and the same and the filing of one claim for exemption will suffice. However, it is not necessary that the owner and the operator of

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the property be the same legal entity. If property is owned by one exempt organization and operated by another exempt organization, each must qualify and file a claim for exemption. If the operator is not an exempt organization, the welfare exemption is not available on the property.

**Specific Requirements for Use of Property.** The Constitution and statutes impose a number of requirements that must be met before property can become eligible for exemption. Nonprofit organizations claiming exemption for their properties must satisfy various organizational requirements and must meet additional requirements that govern the uses of their property. With respect to the use of the property:

- The property must be used exclusively for exempt purposes.
- The property must be used for the actual operation of an exempt activity.<sup>1</sup>
- The property is not to be used to benefit any person through distribution of profits, compensation or the more advantageous pursuit of his or her business or profession.

### **Background**

**Qualification of a Separate Member LLC for the Welfare Exemption.** The welfare exemption is created by Article XIII, Section 4, which authorizes the Legislature to exempt property used exclusively for religious, hospital, or charitable purposes and owned or held in trust by corporations or other entities. In implementing this provision, the Legislature has specified that the “other entities” are to be “community chests, funds (or) foundations.” A Single Member LLC is not one of those entities.

It is generally recognized that only three entities can be used for nonprofit organizations (See CEB, Advising Nonprofit Corporations, § 2.2.):

- an unincorporated association,
- a trust, or
- a nonprofit corporation.

The Legislature has set forth requirements for organization of unincorporated associations (Corporations Code §§2100-21401), for nonprofit public benefit corporations (Corp. Code §§5110-6815) and charitable trusts. California's Trust Law (Probate Code §§15000-19403) applies to charitable trusts to the extent that the Trust Law does not conflict with the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Gov. Code §§12580-12599.5; Probate Code §15004). These are the entities that can qualify for exemption under Section 214.

An LLC can be used to operate a business generating unrelated business income for a nonprofit corporation. (See CEB, Advising Non-Profit Corporations §15.57.) Since the Corporations Code authorizes the creation of an LLC solely for business purposes, an

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<sup>1</sup> The exemption is limited to the amount of property reasonably necessary for the accomplishment of the exempt purpose. Portions of the property in excess of that reasonably necessary for the purposes of the organization do not meet the requirements for property tax exemption and are subject to taxation.

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LLC cannot satisfy the requirements that the property must be owned by one of the specified entities organized and operating for exempt purposes. (Section 4 of Article 13 of the California Constitution and Section 214.) As such, under existing law, property owned by an LLC cannot qualify for the welfare exemption from property taxes in Section 214.

It is well established that constitutional and statutory provisions granting exemptions from taxation are to be strictly, but reasonably construed. In administering such provisions, the Board and county assessors cannot expand their application beyond the plain language of the sections. (*Cedars of Lebanon Hospital v. County of Los Angeles* (1950) 35 Cal.2d 729, 734.)

**Federal and State Treatment of Single Member Limited Liability Companies For Income Tax Purposes - Disregarded Entity.** As of January 1, 2000, the Corporations Code has allowed entities to organize as Single Member LLC. (Corp. Code §§17001, subd. (t); 17050, subd. (d).) Under both state and federal income tax law, a Single Member LLC is treated as an entity that is not separate from its owner and is disregarded for income tax purposes, unless the Single Member LLC elects to be classified as a corporation. (Rev. & Tax. Code §23038; Treas. Reg. Section 301.7701-3(b); Cal. Corp. Code §17254.) As such, a disregarded entity is treated as if it doesn't exist and its assets are treated as being owned directly by its Parent, a sole member nonprofit corporation.

However, the same does not apply to property taxes since the Corporations Code recognizes a limited liability company as a separate legal entity,<sup>2</sup> and there is currently no statutory or regulatory authority for disregarding that separate entity for property tax purposes. The Legislature has conformed franchise tax filing requirements for Single Member LLC's to federal law, but it has not made a similar provision for property tax. As such, property owned by a Single Member LLC would not qualify for exemption under Section 214, for the reasons discussed above, nor would the Board disregard the Single Member LLC's ownership of its property so that the property could qualify for exemption as property of the Parent (nonprofit) corporation.

## COMMENTS

- 1. Sponsor and Purpose.** This bill is sponsored by the author to ensure a property tax exemption for property otherwise eligible for the welfare exemption except for its form of ownership.
- 2. Amendments.** The May 16 amendments delete a provision in the bill that would have specified that property in the course of construction will not be considered "abandoned," and therefore no longer eligible for exemption, in certain instances where bonds will be issued to obtain tax-exempt financing. The April 29 amendments extend the provisions of this bill to any property used for religious, hospital, scientific, or charitable purposes and owned and operated by a single member LLC where the single member is a religious, hospital, scientific, or

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<sup>2</sup> See California Corporations Code section 17000 et. seq which authorizes the creation of LLCs as a recognized entity for businesses in California.

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charitable organization and both the particular property and the particular organization meet all the requirements for the welfare exemption. As introduced, the bill applied only to property used for “health-care” purposes, as specified.

3. **Various nonprofit organizations have approached the Board of Equalization investigating the possibility of reforming as single member LLC’s.** Although staff understands the liability concerns of nonprofit organizations that seek to shield existing assets while acquiring additional real property, staff has responded to those inquiring that, for the reasons stated above, existing property tax law does not permit the welfare exemption to be extended to property owned by single member LLC’s and legislation must be sought.
4. **Mere ownership by a nonprofit corporation of an LLC organized for business purposes does not ensure that the LLC would be organized and operated exclusively for charitable, religious, hospital, or scientific purposes.** While an organization that qualifies as a tax-exempt organization under 501(c)(3) of the Internal Revenue Code can legally form a single member LLC, there is nothing in the law that requires the organization to operate the LLC in a “not for profit” manner. Some nonprofit organizations participate in for-profit business activities unrelated to their exempt purpose, and revenue generated by such activities are subject to tax as unrelated business income.
5. **Currently, California does not expressly provide for the formation of nonprofit LLCs.** Many states allow a LLC to be formed for any “lawful” purpose<sup>3</sup>, whereas California provides that a LLC be formed for a “business” purpose. Consequently, BOE staff recommends that, in addition to amending property tax law, the Corporations Code be amended to allow for the formation of nonprofit LLCs similar to existing provisions that authorize the formation of corporations organized and operated for nonprofit purposes. Specifically, the Beverly-Killea Limited Liability Company Act, Corp Code Sections 17000 et seq..
6. **However, others disagree that it is necessary to amend the Corporations Code to allow for the formation of nonprofit LLCs.** They note that formation of a LLC for a “business” activity does not necessarily follow that the activity must be a “for profit” one. A “business” activity could be either a “for profit” activity or a “not for profit” activity. Supporters note that the articles of organization for the LLC could be written to limit its business activities to those of a nonprofit nature. However, there is no legal obligation to do so in this bill.

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<sup>3</sup> Subject to any limitations contained in the LLC's articles of organization and other applicable laws, a limited liability company may engage in any lawful business activity, with specified exceptions, and shall have all the powers of a natural person in carrying out its business activities. (Corp. Code §§ 17002 and 17003.)

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## **COST ESTIMATE**

The Board would incur some minor absorbable costs in informing and advising County Assessors, the public, and staff of the change in law.

## **REVENUE ESTIMATE**

### **Background, Methodology, and Assumptions**

We are aware of one multi-phase project currently under construction in Riverside County which has applied for the welfare exemption. The claim has been denied, in part, because the form of ownership is a single member LLC. According to the Riverside County Assessor's Office, the total assessed value of the property is estimated to be \$13.5 million upon completion. The annual revenue impact from exempting the property from the basic one percent tax rate would then be \$135,000 (\$13.5 million x .01). However, the facts of each case are critical in determining whether the welfare exemption will be available to a particular property or organization. Although it is clear that this property would not be exempt under the welfare exemption without this bill because of the form of ownership, it is possible that there may be other conditions that would prevent this project from qualifying for the welfare exemption in any case.

### **Revenue Summary**

The annual revenue impact at the basic one percent property tax rate if the property in Riverside County is exempt under the welfare exemption would result in a revenue loss of \$135,000.

In addition, in the last two or three years, several other claims for the welfare exemption have been denied because the properties in each case were owned and operated by a limited liability company. In some of these cases, the nonprofit corporation owner may have decided to change the form of ownership to one that would be eligible to receive the welfare exemption.

Staff estimates that there may be 10 or 20 existing projects throughout the state that would be eligible for the welfare exemption under this proposal. Assuming that each of these has a value in the neighborhood of \$10 million, the estimated total assessed value of these properties is [10 to 20 projects] x \$10 million per project, or \$100 million to \$200 million. The estimated annual revenue impact at the basic one percent tax rate for these projects is \$1 million to \$2 million, [\$100 million to \$200 million x 1%.]

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